

## ANALYSIS OF ORIGINAL BILL

Author: Kaloogian Analyst: Colin Stevens Bill Number: AB 2070

Related Bills: Agency Request 98-06 Telephone: 845-3036 Introduced Date: 2/18/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Interstate Trust Business

### SUMMARY

This bill would allow foreign (other state or nation) banks to transact trust business in California and would place restrictions on those banks' trust activities similar to restrictions currently placed on banks registered in California. This bill also would make other changes to terms and definitions relating to banks engaging in trust activities.

Two separate incidences of taxation are at issue in this bill: The sourcing of income of the trust and the sourcing of income of a foreign (other state or nation) bank or trust company providing newly-authorized trust services. Both are discussed in this analysis.

This analysis does not address the bill's impact on the regulation of banks and trust business activities. This analysis assumes that "noncore banking business" is still considered "banking business" for purposes of the prohibitions in the Corporations Code regarding business activities of a limited partnership and a limited liability company.

### EFFECTIVE DATE

This bill would take effect January 1, 1999. This bill specifies several transitional operative dates for its provisions.

### SPECIFIC FINDINGS

#### Income of the Trust

**Federal law** provides that trusts are taxed in the same manner as individuals. Income generally is taxed to the fiduciary or trustee, if retained by the trust, or to the beneficiary if distributed. Thus, if the fiduciary distributes income to the beneficiary, the trust deducts the distributed income, which then becomes taxable to the beneficiary. Income distributed to beneficiaries retains the same character (capital gain, exempt income, etc.) in the hands of the beneficiary as it had in the hands of the trust.

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
\_\_\_ X \_\_\_ PENDING

#### Agency Secretary Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
DEFER TO \_\_\_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_  
Position Disapproved \_\_\_  
Position Noted \_\_\_

Department Director Date  
Gerald H. Goldberg 5/5/98

Agency Secretary Date

By: Date

Deductions and credits of trusts are basically the same as those allowed to individuals except that a trust is not allowed a personal exemption and is allowed certain special deductions related to administrative expenses.

**California law** generally conforms to federal law with respect to the taxation of trusts and beneficiaries. The taxable income of an estate or trust is computed in generally the same manner as for individuals except certain deductions are allowed for administration, for income paid or set aside by an estate or trust, for income required to be distributed currently and for certain amounts paid or required to be distributed.

**Current state law** provides that the apportionment of income from a trust depends upon the residence of both the trustees and the beneficiaries. If there are multiple trustees and beneficiaries of a trust living in more than one state, the income from that trust will be apportioned according to the number of trustees and/or beneficiaries who reside in California and according to the nature of the beneficiaries' interests (either contingent or non-contingent).

If all interests of the beneficiaries are contingent, the taxation of trust income depends on the residence of the trustee. (However, if no beneficiaries are contingent and all beneficiaries reside in California, all income of the trust is taxable to California.) For apportionment purposes, the residence of a corporate fiduciary of a trust is the place where the corporation transacts the major portion of its administration of the trust. Thus, if the majority of the administration of a trust administered by a corporate fiduciary is conducted outside of California and all beneficiaries are contingent, then income of the trust is not taxable by California until actual distribution from the trust are made to California residents.

**Current state law** prohibits a foreign bank from transacting core banking business in California except at a branch office. Receiving fiduciary assets and administering fiduciary accounts constitute core banking business.

**This bill** would redefine trust business as noncore banking business which may be conducted at a facility in California by banks and trust companies without a branch office in the state. If the majority of the administration of trust services by a trust is conducted outside the state, the income of these trusts would not be subject to California taxation, except when passed through to California residents.

**This bill** would add a "facility" to the list of places a bank can do "noncore banking business" and at which it does not conduct core banking business. "Noncore banking business" is defined as all activities permissible for a commercial bank or independent trust company, except core banking business. **This bill** also would define "independent trust company," "office," "branch," "subject bank," "controlling person," "partial business unit" and other relevant terms.

#### Trust Services Income

**Existing state law** requires corporations with activities both inside and outside California to combine all activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is

combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales. Each factor is the ratio of in-state activity to worldwide activity. However, in apportioning income of banks a single-weighted sales factor is used.

**Existing state law** provides that every corporation that is "doing business" in California is subject to the **corporation franchise tax**. "Doing business" is defined in the code as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The franchise tax is not a tax on income. Rather, the franchise tax is a tax, measured by net income, for the privilege of doing business in the state. Every corporation that is qualified to do business, is doing business in this state (whether organized in-state or out-of-state), or is incorporated in California is subject to the minimum franchise tax.

Under **existing state law**, if a corporation is "doing business" in this state the income that may be apportioned to California for tax purposes includes the income received while engaged in activities in this state and income received from merchandise orders that resulted from those activities in this state. In addition, income from services (including trust services) is considered to be sourced where the services are performed.

Alternatively, **existing state law** provides that corporations not organized in or qualified to do business in California, but that derive income from California sources and are not "doing business" in California, are subject to the **corporation income tax**. However, banks are not subject to the income tax. The minimum franchise tax does not apply to corporations subject to the corporation income tax.

**This bill** would allow trust business to be conducted at a facility (non-branch office) in California and would allow out of state banks and trust companies to solicit trust business in California. If the interests of the trust beneficiaries are contingent and the trust service business is conducted outside of California, the income from these trusts would not be subject to California taxation.

This bill also would allow a foreign (other nation) bank to transact trust business in California if authorized to transact trust business under the laws of its domicile and under the laws of California state banks. **This bill** also would require subject foreign (other state) banks that maintain a facility in California to adhere to the laws of California regarding banks and trusts.

#### Implementation Considerations

This bill would explicitly allow banks and financial corporations organized outside of California to market and solicit trust services in this state without having trust administration operations located in this state. If a bank sets up a facility in this state to engage in trust business, that facility would appear to create nexus, thereby subjecting the bank to California tax. However, if a bank operating as a trust administrator does not locate a facility in this state, but markets out-of state trust services in California, nexus is less clear.

If a majority of the administration of a foreign trust company's services are considered outside of the state and the company has no other income from sources in California, there would be no requirement to file a return or pay California tax on that trust service income.

Finally, this bill would allow foreign banks to receive trust deposits without engaging in other operations in California. Since current law does not require foreign banks to report trust income paid to California residents, this bill could hinder FTB's ability to track trust income paid to California residents.

#### FISCAL IMPACT

##### Departmental Costs

To the extent that this bill raises disputes between the department and trusts over the nexus to tax and makes the tracking of trust income more difficult, this bill may impact the department's costs. The extent of this impact is not possible to determine.

##### Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses as shown in the table.

Estimated Revenue Impact of AB 2070 As Introduced 2/18/98 [\$ in Millions]				
1999-0	2000-1	2001-2	2002-3	2003-4
(\$1)	(\$2)	(\$3)	(\$7)	(\$10)

The bill would be effective with income/taxable years beginning on or after January 1, 1999.

##### Tax Revenue Discussion

By facilitating interstate trust business by state banks and independent trust companies, this proposal is expected to produce revenue losses relative to current law due to the loss of tax revenue on trusts. (A national bank currently may provide trust services in any state, regardless of whether it maintains an office in the state.) This result would occur as in-state business entities lose business to out-of-state companies and/or are able to assign the majority of their trustee operations out of California to remain competitive with out-of-state companies and avoid the tax on trust income.

Currently, trusts pay on average \$140 million annually in state income tax. According to the Department of Financial Institutions, the value of trust assets with state-chartered institutions is approximately one-third of the value of total trust assets with institutions authorized to conduct trust business in California. Due primarily to the issue of beneficiary/trustee proximity that is favored by most beneficiaries, it is anticipated that less

than half of the tax base would be at risk. Losses above reflect an assumed reduction of one-quarter of the trust tax base (attributed to state-chartered institutions) by the fifth full year. The \$800 minimum tax on out-of-state entities would not materially reduce losses.

The revenue implications at the beneficiary level are not expected to be significant relative to current law tax provisions applicable to both contingent and non-contingent beneficiaries.

PROPONENTS OF THE LEGISLATION

This bill is sponsored by the Department of Financial Institutions

BOARD POSITION

Pending.